MASSACHUSETTS ELECTRIC COMPANY AND NANTUCKET ELECTRIC COMPANY

REPLY COMMENTS

September 6, 2002

Submitted to:
Massachusetts Department of Telecommunications and Energy
Docket D.T.E. No. 02-40

Submitted by:

Massachusetts Electric
A National Grid Company

Nantucket Electric
A National Grid Company

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COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation into the Provision of Default Service) Docket D.T.E. 02-40

REPLY COMMENTS OF
MASSACHUSETTS ELECTRIC COMPANY
AND
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I. Introduction

These reply comments by Massachusetts Electric Company and Nantucket Electric Company (together "Mass. Electric") respond to the comments of the other parties to this proceeding. The Department's Notice of Inquiry has drawn significant interest and a broad range of comments. Despite their apparent disparity, a significant core of agreement underlies the comments. Specifically, the parties are in general agreement that the large commercial and industrial ("C&I") market for electricity is developing to provide customers with meaningful supply choices, but that these choices are not yet available to residential and small C&I customers. Moreover, with regard to the small customers, the parties have developed a range of views that can be reasonably evaluated by the Department. These reply comments discuss the alternatives suggested by the parties for residential and small C&I customers, and then discuss a series of specific issues raised by the initial comments. We rely on our initial comments to address the other issues raised in the comments of the other parties.

II. The Alternatives for Residential and Small C&I Customers

The initial comments filed in this proceeding contain a range of alternative recommendations for the Department's consideration. These alternatives can be arrayed on a continuum, which provides the Department with a series of options that could be used to improve procurement, create value, and develop new market alternatives for electricity supply to residential and small C&I customers in Massachusetts. Nearly all parties are in agreement that some improvements are necessary and appropriate for these classes of customers. The differences lay in the specific steps that the parties recommend.

A. Improved Wholesale Procurement

1. The Principles of the Attorney General et al.

At one end of the spectrum are the principles that have been articulated by the Attorney General, the Massachusetts Community Action Program Directors Association, Inc., and NSTAR Electric ("Principles"). Those Principles recognize that "smaller customers have not had significant access to competitive retail electric markets" and suggest that continued supply by utilities "may be the only viable energy option for small, residential and low-income customers for the foreseeable future" (Principles, Section I). Nevertheless, the Principles recognize that some change is appropriate for the procurement of wholesale supplies of default service by distribution companies. Specifically, the Principles suggest that: "Default Service for small customers should be procured and priced over a longer term, in order to assure greater price stability for those customers," and that: "Any mandated procurement process for Default Service should be flexible enough to allow utilities to make purchases that are in the customers' best interests and result in the lowest reasonable price for customers" (Principles, Section II).

Although these Principles recognize that some action is appropriate to mitigate the fluctuations for residential and small C&I customers after the end of the standard offer, the Principles are lacking in any specific suggestions for those improvements. The specific suggestions are provided by the DOER proposal.

2. The DOER Proposal

The DOER comments set forth a concrete proposal for improved wholesale procurement of default service by distribution companies that is generally consistent with the Principles articulated by the Attorney General et al. Under the DOER proposal, distribution companies would buy one eighth of their default service requirements at wholesale each quarter using a two year contract, and would average the prices of the eight winning bids to arrive at a retail default service price. The proposal procures wholesale default service over a longer term, and averages the costs from the prior seven quarters with the new winning bid "to assure greater price stability" for residential and small C&I customers, as suggested by the Attorney General's Principles. Moreover, the DOER proposal could be easily adapted to allow additional purchasing flexibility to reflect current market conditions and reduce procurement costs in a way that would meet the Attorney General's final principle that recommends flexibility in the procurement process.

As we indicated in our initial comments (pp. 6-7), the adoption of the DOER proposal represents the minimum step that is required to improve the procurement of default service for residential and small C&I customers after the end of the standard offer period. The customers in this group today lack market alternatives. Thus, it is necessary either to develop new market options or to improve the default service that is now being provided by the distribution company to these classes of customers. The DOER proposal focuses on the second alternative and improves default service by limiting the price fluctuations associated with the shorter-term contracts between distribution companies and their suppliers under current practice.

However, the DOER proposal may actually impede the development of the retail market by setting the default service benchmark price equal to the trailing average price of procurement by the distribution company. The trailing average price will prevent the retail marketer from competing with the benchmark price when market prices are rising, and as a result may perpetuate the boom/bust cycle for retailers that has been experienced in other states. Moreover, the DOER proposal, which is focused on wholesale procurement by the distribution company, does not create or capture any value from the development of the retail market place.

B. Developing the Retail Market

1. Use of the Contract Clearing Price

In its initial comments, Mass. Electric addressed both retail pricing and the creation of value through the development of the retail market. To prevent the pricing of default service from impeding the development of the retail market, Mass. Electric proposed to change the methodology for retail pricing from the average of the winning bids suggested by the DOER (the "average cost price") to the highest of the winning bids in the contracts in place to serve the eligible customers (the "contract clearing price"). Under Mass. Electric's proposal, the difference between the default service power supply costs (which are equal to the average costs from the wholesale or retail suppliers' bid prices as in the DOER proposal) and the retail revenues collected (which are based on the contract clearing price) is returned to customers through a retail value credit. The retail value credit assures that customers are only charged the actual cost of providing the service.

Nevertheless, the use of the higher contract clearing price for retail pricing purposes prevents the default service benchmark from undercutting the current retail market, and provides an incentive for the market to develop. As explained in our initial comments (pp. 15-19), the retail value credit would be given to all non-standard offer service customers, whether or not they receive competitive service under contracts with retail suppliers.[1] In this way the customers do not lose the credit by moving to the market, yet the use of the higher clearing price allows retailers to generate value by executing contracts with customers under the default or basic service price.

The change in the retail pricing methodology can be implemented even if the distribution company remains as the default service provider and procures the supplies for this service directly from the wholesale market. In our initial comments (pp.10-12), we suggested that Mass. Electric should maintain the wholesale option in its procurement

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[1] Prior to the end of the standard offer, the retail value credit would apply to all non-standard offer customers in the residential and G-1 classes, whether or not those customers were taking service from the competitive market. After the end of the standard offer, the retail value credit would apply to all residential and G-1 customers.

Mass. Electric proposes to use flat per kilowatthour bids to implement its pricing proposal, rather than the monthly-differentiated price suggested by the DOER (DOER Comments, pp. 24-25). The implementation of the contract clearing price under Mass. Electric's proposal requires the use of the winning contract with the highest price, implements a retail value credit each quarter, and requires quarterly price changes. We believe that the addition of seasonal or monthly prices would likely add customer confusion without informational benefit. In addition, to the extent that monthly pricing is implemented before the end of the standard offer, monthly pricing may result in default service prices fluctuating above and below standard offer service prices from one month to the next adding more confusion for customers.

process. Even if that option is used exclusively, the Department should consider the use of the higher contract clearing price. The use of the contract clearing price will prevent default service pricing from impeding the development of the retail electricity supply market. It eliminates the lagging average retail price that can undercut retailers who are procuring new power supplies in a rising wholesale market. The elimination of this problem is necessary to allow a retail market to develop.

However, it is possible that even after the contract clearing price has been implemented, the retail market may not take hold. In that event, customers will pay the same total bill under the contract clearing price with the retail value credit as they would under the DOER's proposed average cost method. Significant differences in the default service customer's total bill will only occur if the market develops and a substantial number of customers begin to be supplied by retailers. As we indicated in our initial comments (pp. 17-19), if this occurs, we believe that we can monitor and manage bill impacts to remaining default service customers who are unable to find an alternative supply.

2. The Retail Option

The DOER's proposal, even with the use of the contract clearing price as suggested above, does not use the end of the standard offer as an affirmative opportunity to create a retail market. As a result, the DOER proposal does not fully capture the value that may be added by facilitating the entry of retail suppliers into the market, first as suppliers of default service and then as contract suppliers to residential and small C&I customers. We believe that facilitating entry of retail suppliers through the design of

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Accordingly, we do not recommend monthly pricing. Rather, under our proposal, we would require all suppliers in the quarterly auctions to bid a flat cents per kilowatthour price for the two-year contract period.

default service auction process can produce substantial value for all residential and small C&I customers through more attractive bids for default service and through lower prices and increased value in new market offerings. To attempt to capture this value, we have developed the retail auction proposal that was set forth at length in our initial comments. The underlying focus was to facilitate entry by eliminating as much up-front investment and acquisition costs for retail suppliers as was reasonably possible. Our hope and expectation is that the value created for suppliers would then produce more attractive and aggressive bids for default service supply than would have been otherwise achieved. The theory is that savings to marketers in the costs of acquiring customers and building economies of scale in their Massachusetts operations would be reflected in lower bids for default service supply.

We realize that, given economic conditions and uncertainties in the retail and wholesale power markets, our hopes and expectations may not be fulfilled. As a result, in our initial comments (pp. 10-12), we modified the design of our proposal to include wholesale procurement as an option, assuring that the retail option will be selected in the auction, only if the retail supply produces incremental value for our customers. Moreover, by retaining responsibility for billing, customer service, and collections, we have designed the retail option in a way that maintains customer protections and limits risks to customers if the program does not work. In the event of a failure, our proposal allows us to move seamlessly back to wholesale procurements and resume the responsibility for retail supply. Given these protections, we believe that the potential benefits to residential and small C&I customers from facilitating the development of the market justify the effort.

3. Maintaining Billing, Customer Service, and Collections

At the other end of the spectrum, TXU Energy Retail Company LP ("TXU") and Centrica North America (comments pp. 17-18) suggest that retail suppliers should become responsible for billing, customer service, and collections as well as default service supply. As TXU recognizes, this approach requires significant revisions to Chapter 164 of the General Laws and is beyond the Department's authority under the current statute (see TXU Exhibit 1). More important, the TXU proposal does not represent sound policy at this point in the development of the retail market in Massachusetts. As we explained in our initial comments (p. 22, n. 3), the TXU proposal does not allow seamless recovery in the event of a supplier failure, does not maintain consistent consumer protections for all customers in the class, creates a barrier to entry to new suppliers who must invest in new billing systems and back office operations, produces duplicative systems and costs, has created serious customer service problems in other jurisdictions, and disrupts the operation of the Massachusetts EBT infrastructure, which is among the most efficient and effective in the country.

Unlike the Mass. Electric proposal, which is flexible and reversible in the event of a supplier failure, the TXU plan would expose customers directly to significant risks and substantial costs. These risks and costs have already been experienced by the gas customers in Georgia. <u>See Final Report of the Governor's Blue Ribbon Natural Gas Task Force</u> (February 5, 2002). These risks and costs do not need to be incurred to improve default service in Massachusetts. We do not need to disrupt billing, introduce fragmented customer service and unequal customer protections, deal with arbitrary and inaccurate terminations, and introduce impediments to the efficient transfer of customers among competing retail suppliers to improve default service to our customers. The Department should not expose Massachusetts electric customers to these risks and costs in this proceeding.

III. Specific Issues

In addition to the general discussion set forth above, several parties raised specific issues associated with Mass. Electric's proposal or the provision of default service in general. Each of those issues will be dealt with briefly in this section. To the extent not expressly addressed, we rely on our initial comments to set forth our position.

A. Legal Authority

The legal issues associated with Mass. Electric's proposal were discussed in our initial comments at pages 29 to 33. In his initial comments (p. 4, n. 5), the Attorney General has raised the issue of whether the retail auction might run afoul of 940 CMR s. 19.06(1)(d), the Attorney General's anti-slamming regulation. The regulation as drafted expressly references G.L. c. 164, s. 1B(d) and provides that "It is an unfair or deceptive act or practice for a retail seller of electricity to: . . . (d) replace or arrange to replace a consumer's current provider of electricity with its own service or with the service of any other retail seller of electricity, without the consumer's express, affirmative consent, except as provided by M.G.L. c. 164, s. 1B(d) or s. 134" (emphasis supplied). As we explained in our initial comments (pp. 30-32), G.L. c. 164, s. 1B(d) expressly authorizes the shift of default service from a distribution company to an "alternate generation company or supplier" when the Department finds that it is in the public interest. The Attorney General's regulation incorporates the statute, and must be applied consistently with the statute. The Department should find that it is not an unfair or deceptive practice to replace the distribution company with an alternative supplier when the Department has found that such transfer is in the public interest under Section 1B(d).

B. Renewable Resources

Several parties recommend that the Department evaluate the provision of renewable resources in the context of this proceeding. See Joint Comments filed by the Conservation Law Foundation, Massachusetts Energy Consumers Alliance, and the Massachusetts Technology Collaborative. These comments focus on the impact that the procurement of default service can have on the development of renewable resources. The renewables proponents are focused primarily on the development of green options in the retail market place and the need for longer-term commitments for the development of new renewable resource projects. See Mass. Technology Collaborative Comments, pp. 5-6; CLF Comments, pp. 5-6. Neither of these objectives is being met by the current design of default service procurement (Mass. Technology Collaborative Comments, pp7-8; CLF Comments, pp.5-9). Accordingly, the renewables proponents suggest that distribution companies be encouraged or required to engage in longer-term commitments for renewable resources.

Mass. Electric believes that its proposal represents a much better approach to the development of renewable resources than the return to mandated purchases by distribution companies under extensive administrative oversight. Under our proposal, retail suppliers will have the opportunity to enter the market and develop longer term portfolios of renewable resources for their customers. Moreover, the retailers will be able to use renewable commitments made for the purpose of default or basic service supply to structure an attractive contract option for customers. The experience in the market indicates that the environmental sustainability of the power supply portfolio is one of the best ways to differentiate a retailer from its other competitors. The Mass. Electric proposal allows the green marketers to arrange significant supplies up-front, and then use these supplies to create an attractive marketing product for their customers.

Mass. Electric's proposal both extends the contract horizon and facilitates the retail market. The Department should give the proposal a chance to work before engaging in the more intrusive and less efficient method of forced long-term commitments by distribution companies with renewable generators. The administratively determined targets for renewables contracts by utilities suggested in the comments (Mass. Technology Collaborative, pp. 10-12; CLF, pp. 9-11) raise the default service baseline that independent marketers must exceed to differentiate their renewable product offerings, increase the costs of renewable purchases by these retailers, and create a hurdle for the development of the retail renewables electricity market. Mass. Electric's proposal seeks to create a better opportunity for the market to meet renewable portfolio targets, and to create new renewables options for customers. The Department should allow it to go forward.

C. Unbundling of Administrative and Bad Debt Costs

Under Mass. Electric's proposal for providing basic service to residential and small C&I customers, suppliers (whether retail or wholesale) would be directly allocated bad debt risk, and would only be paid what is actually received from customers associated with their bid price for commodity. Moreover, those suppliers who serve at retail would be expected to meet their own retailing requirements, and thus would face costs that are comparable to those faced by other suppliers in the market. As a result, for retail suppliers, no further unbundling or backout credit is necessary under Mass. Electric's proposal.

In the comments, we also indicated a willingness to accept wholesale bids, under which the wholesale supplier would not be required to register as a retail supplier directly. These wholesale suppliers would avoid incurring some administrative costs that would otherwise be faced by retailers. However, the continuation of the wholesale option does not give rise to any additional administrative expense for Mass. Electric. Mass. Electric must perform an auction under any circumstance; it is simply providing the bidders with an additional option. As a result, we do not see any basis for providing a "credit" for administrative cost savings as part of the implementation of our proposal.

Moreover, as we explained in our initial comments (pp. 25-26, 34), the costs and savings associated with the implementation of default service options for Mass. Electric are determined largely by our settlement in Docket No. D.T.E. 99-47. Several parties have suggested alternatives that should be applied to these costs in the absence of a settlement, but we believe that the settlement should govern their treatment for Mass. Electric.

IV. Conclusion

The Department has been presented with an array of options that can be used to improve default service procurement in the wholesale market or to facilitate the development of the retail market. We continue to believe that our proposal has the potential to produce significant benefits for our customers, and can be implemented in a way that is entirely consistent with the Massachusetts restructuring statute and that limits any down side risks to our customers. Accordingly, we ask that the Department endorse the general approach for implementation by Mass. Electric, and then convene a series of technical sessions to work through the details with the parties leading to a filing by Mass. Electric that will implement the proposal.

Respectfully Submitted,

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